Senior European Experts

Bank Recovery & Resolution: European Commission Proposals

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Introduction

In June 2012 the European Commission published proposals for new legislation on the rescue and refinancing of banks in difficulty (referred to as "recovery and resolution") designed to address the regulatory gaps exposed by the global financial crisis, in particular the cross-border nature of modern banking.[1] These proposals are part of the package of measures known as banking union, which taken together are intended to create a safer, more stable banking system following the events of the global financial crisis and the related eurozone difficulties.

The proposed measures which apply to all Member States and not just the eurozone, are based on existing Treaty provisions on the Single Market and are subject to the approval of Member States in the Council (by QMV) and of the European Parliament. Even if they are accepted and become law, they would not come into force until 1 January 2015 so they are not a solution to the current eurozone crisis but they are part of the framework for preventing future crises. Their adoption could however increase market confidence in banks and other financial institutions.

A separate Senior European Experts paper outlines the overall proposals for banking union.[2]

Background

The Senior Experts paper 'The EU and the Global Financial Crisis' sets out the background to the crisis and the initial response of the EU. In particular it documents the emergency measures necessary to recapitalise banks in the EU (and, indeed, in the US). Between October 2008 and October 0211 €4.5 trillion of public support and guarantees was used by EU Member States in rescuing banks.[3] After the initial phase of the crisis, the EU established a high-level group to look at financial supervision in the EU. The report of this commission led to the establishment of new regulatory bodies described in the SEE paper, 'Financial Supervision in the EU'.[4]

In describing the context of its current proposals, the Commission highlights the difficulties that Member States and EU institutions faced during the financial crisis (and are still facing) in managing difficulties in banks. It also notes that the increasing interdependence of financial

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[1] European Commission, *Proposal for a Directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directives 77/91/EEC and 82/891/EC, Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC and 2011/35/EC and Regulation (EU) No 1093/2010*, COM (2012) 280 Final, 6 June 2012

[2] Senior European Experts, *Banking Union: Proposals for Banking Regulation*, October 2012

[3] European Commission, *Towards a banking union*, MEMO/12/656, 10 September 2012

[4] Senior European Experts, *Financial Supervision in the EU*, September 2011

services in the EU means that a problem in a bank in one Member State can quickly spread to others in other Member States; and banks have become so large that they cannot be allowed to fail because if they do, the repercussions for the whole financial system are so serious.

The Commission also draws attention to the G20's agreement in April 2009 that there should be a:

> review of resolution regimes and bankruptcy laws in light of recent experience to ensure that they permit an orderly wind-down of large complex cross-border institutions.

In December 2010 the Economic and Financial Council of the EU (ECOFIN) issued its own call for an EU-wide framework for crisis prevention, management and resolution in the financial sector. The Commission published options for consultation in January 2011 and held detailed discussions with experts on particular aspects of the proposals.

The Proposals

The Commission's paper says, because of the nature of the financial system, the usual insolvency procedures may not be appropriate for winding down a failing bank and so a special procedure is needed. Such a system needs to better protect the interests of taxpayers who in the present crisis have had to pick up the bill for rescuing banks.

The powers needed by authorities to deliver this would have three elements:

- preparation and prevention powers to plan for and preferably prevent failure;
- early intervention in the event of a bank beginning to deteriorate;
- insolvency and resolution powers to wind down a bank in trouble before its difficulties cause wider problems and place a burden on taxpayers.

The Commission argues that, taken together, these powers would be sufficient to deal with the recovery of any institution in difficulty or its orderly winding down if it could not be rescued.

Preparation and prevention powers

Under this element, the aim is to give public authorities the necessary powers to prevent a bank from failing. The key method for doing this would be the requirement on such institutions to have recovery plans. A bank or other institution's plan would set out, the:

> arrangements and measures to enable it to take early action to restore its long term viability in the event of a material deterioration of its financial situation.

Banking groups would have to have recovery plans for the group as a whole and individual banks within the group would also have plans. The plans would be assessed and approved by national regulators.

The regulatory authorities would in turn have to outline the steps they would take when intervening and managing a bank in crisis. These resolution plans would outline how the

regulator would act to ensure an early response to a bank's capital reserves falling below a set level (there is obviously a read across here to the internationally agreed requirement for banks to have a certain level of capital assets). The resolution plans would address such issues as how to ensure the continuity of essential banking functions in the event of a bank being in crisis.

Early intervention

The Commission's proposed legislation would give the regulators new powers to intervene at an early stage when a bank was developing problems. These additional powers include the power to require an institution to take various actions, such as:

- implement arrangements and measures set out in the recovery plan;
- to draw up an action program and a timetable for its implementation;
- to request the management to convene, or convene directly, a shareholders' meeting, propose the agenda and the adoption of certain decisions; and
- to request the bank to draw up a plan for restructuring of debt with its creditors.

These powers, set out in Articles 23-26 of the draft directive included with the Commission's paper, also include the more significant step of the regulators appointing a special manager to replace the bank's existing management with the primary duty of restoring "the financial situation of the institution and the sound and prudent management of its business". The Commission sees this unusual power as "an element of discipline" for managers and shareholders and as a means for fostering private sector solutions to the problems of banks.

Insolvency & resolution powers

A central part of the Commission's proposals is a new method for resolving the problems of banks that are in too bad a situation to enable them to be easily rescued. Getting this aspect of the policy changes right is critical to reducing the so-called "moral hazard" where failing banks are said to be "too big too fail" and therefore have to be rescued by public authorities at a high cost to taxpayers.

The Commission argues that this unique procedure is needed because normal processes of insolvency are ineffective in these cases. The aim of the new approach is to achieve the same results as a conventional insolvency procedure – *e.g.* the allocation of losses to creditors and shareholders – but also to provide legal certainty, with greater predictability and transparency for shareholders and creditors as well as preserving value that would be lost in a bankruptcy.

The proposed approach of the Commission is that the European Banking Authority should have the power to issue guidelines and set technical standards so that application of resolution powers is consistent across the EU. They would also participate in resolution planning in relation to cross-border banks. But crucially, the necessary funds to enable bank rescues would come from the private sector and not the state (see below).

Regulators would have to judge carefully when to intervene because of the consequence for shareholders of them doing so. One of the principles of the new resolution procedure is that no creditor of a bank that is the subject of this procedure should be worse off than if

normal insolvency procedures had been followed. A resolution fund would enable the payment of compensation if this situation occurred.

The four basic resolution tools are:

- sale of the bank;
- bridge institution – *i.e.* transferring all or part of the bank temporarily to a state-owned financial institution that would operate under commercial rules;
- asset separation – *i.e.* separating good and bad assets; this would happen in all cases where the resolution procedure applied;
- bail-in – *i.e.* a requirement on bond holders to take a loss on their investment in order to keep an institution solvent.

Member States would be able to have additional resolution tools in their national law provided they did not clash with the minimum requirements above, EU treaties or the resolution of groups of banks.

The power to order a bail-in is probably the single most controversial proposal the Commission has put forward. The EU is not alone in adopting this approach however; the US Dodd-Frank financial reform act of 2010 contains a bail-in type of resolution procedure. What the power will do is to enable regulators to write down the claims of creditors and to convert debt claims to equity. This would disadvantage bond holders in a bank or other financial institution but it would give them an incentive not to lend to banks with imprudent lending policies and it would reduce the call on the taxpayer in the event of a bank failing.

Other issues

Greater co-operation will be needed between national regulators to ensure recovery and resolution plans deal effectively with groups. Existing regulations enable the European Banking Authority to make bilateral arrangements with third countries in order to deal with banks with businesses outside as well as inside the single market. The new resolution procedure would be fully applicable to third country institutions operating in a Member State.

In order to ensure the orderly winding up of failing banks, the Commission proposes the establishment of resolution funds, established in each Member State, resourced through contributions from financial institutions but supplemented with lending from the national central bank if absolutely necessary. The Commission says that the ideal size of this fund would be one per cent of the guaranteed deposits held by financial institutions in a Member State but suggests that this would take 10 years to achieve.

Next Steps

The Commission would like these proposals to be law by the end of 2014. As with all such single market legislation, agreement will be required from the Council and the Parliament. Inquiries by the scrutiny committees of both Houses of Parliament can be expected. The British Government has welcomed the Commission's proposals – which mirror those in the UK's 2009 Banking Act and which are compatible with the White Paper on banking also

published in June. The Financial Secretary to the Treasury said that "the Government expects the net benefits to the UK to be positive" of the Commission's proposals.

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Senior European Experts

The Senior European Experts Group is an independent body consisting of former high-ranking British diplomats and civil servants, including several former UK ambassadors to the EU, and former officials of the institutions of the EU.

The group provides high-quality, fact based briefing materials on EU issues.

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